

### Class Exercise 3

## **Hedging with Foreign Exchange Futures**

Agreement on delivery / price of California wine to UK made on March 1:

“To sell 1000 bottles at 6.25 British Pounds per bottle, with payment due on June 15.”

### **How many US Dollars can exporter expect to receive when payment is made?**

On March 1, the “Futures Price” of the GBP for June 17 delivery is \$1.5070. Exporter can expect to receive this value, or a total of \$9,418.75 (\$9.42 per bottle)

#### Scenario 1: The Pound gets stronger

On June 15 – the date of payment, the GBP is stronger, with a “spot” rate of \$1.5876.

When payment is transferred, 6,250 GBP yields \$9,922.5 (\$9.92 per bottle).

Currency gain is \$503.75.

#### Scenario 2: The Pound gets weaker

On June 15 – the date of payment, the GBP is weaker, with a “spot” rate of \$1.4358.

When payment is transferred, 6,250 GBP yields \$8,973.75 (\$8.975 per bottle).

Currency loss is \$445.00.

### **Hedging with Currency Futures:**

#### *Scenario 1:*

*Exporter “sells” GBP futures at the March 1 price of 1.5070 and “buys” out his contract on June 15 at 1.5876*

March 1: “Sell” 6,250 GBP at 1.5070 = \$9,418.75

June 15: “Buy” 6,250 GBP at 1.5876 = \$9,922.50

Net loss on Trade = \$503.75

Loss on Trade is balanced by currency gain on sale of wine

#### *Scenario 2:*

*Exporter “sells” GBP futures at the March 1 price of 1.5070 and “buys” out his contract on June 15 at 1.4358*

March 1: “Sell” 6,250 GBP at 1.5070 = \$9,418.75

June 15: “Buy” 6,250 GBP at 1.4358 = \$8,973.75

Net gain on Trade = \$445.00

Gain on Trade is balanced by currency loss on sale of wine.

***In either scenario, changes in currency exchange rate result in no change in final dollars received, as “locked in” on March 1.***

**Note:** This is a simple case to illustrate the effect of “hedging” foreign exchange risk. There are many variables, including differences in dates of payment vs. ending date of “buy” or “sell” contract; size of contracts, etc. which you will need to research further before making “hedge” trades in the foreign exchange futures market.